

In the Supreme Court of the United States

OCTOBER TERM, 1991

GARY L. SIBEN, ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

KENNETH W. STARR
Solicitor General

SHIRLEY D. PETERSON
Assistant Attorney General

ANN B. DURNEY
JANET KAY JONES
Attorneys
Department of Justice
Washington, D.C. 20530
(202) 514-2217

QUESTION PRESENTED

Whether deficiencies in petitioners' income taxes, resulting from the Commissioner's disallowance of deductions reported by a partnership in which they were partners, are time-barred because the deficiencies were asserted within an extended limitation period agreed to by petitioners but more than three years after the partnership filed its information returns.



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OCTOBER TERM, 1991

No. 91-312

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v.

COMMISSIONER OF INTERNAL REVENUE

*ON PETITION FOR A WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT*

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-21a) is reported at 930 F.2d 1034. The Tax Court's memorandum opinion (Pet. App. 22a-28a) is reported unofficially at 60 T.C.M. (CCH) 524.

JURISDICTION

The judgment of the court of appeals was entered on April 18, 1991. A petition for rehearing was denied on May 31, 1991 (Pet. App. 37a-38a). The petition for a writ of certiorari was filed on August 20, 1991. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Petitioners are partners in Baltic Realty Ltd. (Baltic), a limited partnership. On their 1979 and 1980 federal income tax returns, petitioners claimed deductions for their respective shares of losses reported on Baltic's partnership information returns filed for those same years. In conjunction with an Internal Revenue Service (IRS) audit, petitioners executed special consents to extend the statute of limitations on assessments of tax for their 1979 and 1980 taxable years. Petitioners explicitly limited these extensions to items of income or loss associated with Baltic. Since Baltic, as a partnership, is not itself a taxable entity, Baltic was not requested to execute a similar extension of the limitations period. See Pet. App. 4a, 24a-26a.

In December 1984, within the extended limitations period agreed to by petitioners, but more than three years after Baltic had filed its information returns, the IRS issued notices of deficiency to petitioners. The tax deficiencies resulted from disallowance of the deductions claimed by petitioners for the losses incurred by Baltic. Pet. App. 24a-26a.

2. After petitioning the Tax Court for a redetermination of the deficiencies asserted by the IRS, petitioners moved for summary judgment on the ground that the statute of limitations for the assessment and collection of the taxes at issue had expired prior to the issuance of the deficiency notices. Relying on *Kelley v. Commissioner*, 877 F.2d 756 (9th Cir. 1989), petitioners contended that the statute of limitations expired three years after Baltic filed its partnership return because the deficiencies at issue were based upon the disallowance of deductions for losses of Baltic. Pet. App. 26a.

The Tax Court denied petitioners' motion. Pet. App. 29a-30a. In doing so, the court relied upon its reviewed decision in *Fehlhaber v. Commissioner*, 94 T.C. 863 (1990), appeal docketed, No. 90-5735 (11th Cir. Sept. 6, 1990), in which a unanimous Tax Court held that an information return filed by a subchapter S corporation did not trigger the three-year statute of limitations on assessments of tax against its shareholders. In *Fehlhaber*, the Tax Court expressly declined to follow *Kelley v. Commissioner*, 877 F.2d at 759, in which the Ninth Circuit held that the filing of an information return by a subchapter S corporation triggered the statute of limitations on assessments against the shareholders. See Pet. App. 22a-28a. After certification by the Tax Court and permission from the court of appeals, petitioners appealed from the Tax Court's interlocutory order. *Id.* at 34a-36a.

3. The court of appeals affirmed (Pet. App. 1a-21a). Stating that "the 'return' " that starts the running of the limitations period in Section 6501(a) of the Internal Revenue Code "is that of the taxpayer whose liability is being assessed, and not that of a third person or entity whose return might also report the transaction that gives rise to the liability" (Pet. App. 7a), the court held that the deficiencies were asserted within the statutory period, as extended by petitioners (*ibid.*). The court based its construction of Section 6501(a) in part on the fact that a partnership is not subject to income tax and thus its informational return could not be "the return" that begins the limitations period for assessing federal income tax. The court of appeals also found its reading of Section 6501 consistent with decisions in which this Court has made clear that "the return" that starts the running of Section 6501's limitations period must con-

tain all the data necessary for the computation and assessment of the tax. Pet. App. 7a, 9a-11a citing *Automobile Club v. Commissioner*, 353 U.S. 180 (1957); *Commissioner v. Lane-Wells Co.*, 321 U.S. 219 (1944); *Germantown Trust Co. v. Commissioner*, 309 U.S. 304 (1940).

Because Baltic's partnership return lacked the information necessary to compute petitioners' income taxes, the court concluded that the filing of the partnership's return did not start the limitations period for assessing a tax against its partners. Pet. App. 11a-12a. The court rejected as "readily distinguishable" the two cases on which petitioners primarily relied, *Kelley v. Commissioner*, 877 F.2d 756 (9th Cir. 1989) (holding that expiration of the limitations period against a subchapter S corporation barred any assessment against shareholders relating to income attributed to shareholders from the subchapter S corporation) and *Fendell v. Commissioner*, 906 F.2d 362 (8th Cir. 1990) (holding that expiration of the limitations period against a trust barred any assessment against a beneficiary relating to income from the trust). See Pet. App. 1a-21a.¹

ARGUMENT

The decision below correctly holds that the statute of limitations for assessing additional income tax against a partner based on adjustments to partnership income is measured from the date of filing the partner's income tax return and not from the date the partnership's return is filed. The decision is in accord with decisions of this Court and does not directly conflict with any decision of any other court of appeals. Further review is therefore not warranted.

¹ The court also expressed doubt whether *Kelley* and *Fendell* had been correctly decided. See Pet. App. 17a, 20a.

1. Section 6501(a) of the Internal Revenue Code provides in relevant part that "the amount of any tax imposed by this title shall be assessed within 3 years after the return was filed * * * and no proceeding in court without assessment for the collection of such tax shall be begun after the expiration of such period." Section 6501(c)(4) permits consensual extensions of this statutory period.

As the court of appeals concluded, "the return" that reports the income tax "imposed by this title," and that commences the three-year period provided by Section 6501(a), is "that of the taxpayer whose liability is being assessed, and not that of a third person or entity" (Pet. App. 7a). With exceptions not here relevant, Section 6012(a) requires "[e]very individual" with gross income for the taxable year in excess of the prevailing exemption amount to make a return "with respect to income taxes under subtitle A." 26 U.S.C. 6012(a). The income tax provisions affecting partnerships, however, are very different. The return of a partnership is a return of income, but not of income tax. The partnership return is a purely informational return. It does not provide all of the information on the basis of which an income tax can be assessed or a suit to collect an income tax can be begun. Cf. *Automobile Club v. Commissioner*, 353 U.S. 180 (1957).

Section 701 of the Internal Revenue Code, provides:²

² In 1982, after the years here at issue, Congress (in Sections 401-406 of the Tax Equity and Fiscal Responsibility Act, Pub. L. No. 97-248, 96 Stat. 648-670) added Sections 6221-6232 to the Internal Revenue Code, initiating unified administrative proceedings for partnership returns, providing for notice to, and participation by, partners, the designation, responsibility, and authority of a "tax matters partner,"

A partnership as such shall not be subject to the income tax imposed in this chapter. Persons carrying on business as partners shall be liable for income tax only in their separate or individual capacities.

Successive sections of the Internal Revenue Code provide that each partner shall take into account his distributive share of partnership accounts in determining his income (Section 702), establish the method of partnership computations (Section 703), and provide a definition of a "partner's distributive share" of partnership accounts (Section 704). See *United States v. Basye*, 410 U.S. 441, 448-449, 453-456 (1973). Section 6031(a) requires the partnership to make an annual information return stating the gross income and deductions of the partnership, identifying the partners, and giving "the amount of

and specific procedures regarding the auditing and adjustment of partnership returns. (Since only partners, and not partnerships, are liable for income tax, the Commissioner asserts "adjustments" to partnership returns, rather than "deficiencies", in the event of error or omission.) The statute provides (Section 6226) for judicial review of partnership administrative "adjustments" by the Tax Court, a district court, or the Claims Court, with restriction of assessment of deficiencies against partners arising from partnership adjustments until the period for initiating judicial review has passed, or review becomes final. Section 6229 provides a three-year limitation period from the filing of the partnership return for assessments against partners, unless extended by agreement with an individual partner for himself, or by agreement with the "tax matters partner" for all partners. In the event of a notice of final administrative "adjustment", the running of the period of limitations will be suspended for the period during which judicial review may be sought, and, if sought, until it becomes final, and for one year thereafter.

the distributive share of each individual.” 26 U.S.C. 6031(a). As these provisions demonstrate, partnership informational returns do not fall within the *income tax* return requirement of 6501(a), for there can be no assessment of income tax (or suit to collect income tax) against a partnership. There is no basis on which a partnership could agree to extend the statute of limitations on assessment or suit under Section 6501(a), since the statute does not apply to it.³

The court of appeals thus correctly held that the statute of limitations in Section 6501 did not bar the assessment of additional income taxes against petitioners for the taxable years 1979 and 1980. See also *Durovic v. Commissioner*, 487 F.2d 36, 38-40 (7th Cir. 1973) (partnership’s informational return does not commence the limitations period for individual tax returns), cert. denied, 417 U.S. 919 (1974).

2. Petitioners assert (Pet. 8-27) that the decision in this case conflicts with *Kelley v. Commissioner*, 877 F.2d 756 (9th Cir. 1989), involving shareholders of a subchapter S corporation, and *Fendell v. Commissioner*, 906 F.2d 362 (8th Cir. 1990), involving

³ Notwithstanding these explicit provisions, petitioners invoke the decision of this Court in *Burk-Waggoner Oil Ass’n v. Hopkins*, 269 U.S. 110 (1925). That case involved “an unincorporated joint stock association” (269 U.S. at 110) characterized as a partnership under Texas law. Under provisions now appearing as Section 7701(a)(2) and (3) the Court held that the organization was an association taxable as a corporation. Cf. *Morrissey v. Commissioner*, 296 U.S. 344 (1935). The decision has no bearing upon whether partnerships are taxable entities under Section 701 of the Code.

the beneficiary of a complex trust.⁴ We believe that *Kelley* and *Fendell* are erroneous.⁵ Because the income tax treatment of partnerships differs from the treatment afforded to S corporations and trusts, however, there is not a clearly articulated, direct conflict between *Kelley* and *Fendell* and the decision in this case.

a. Sections 1371-1379 (1976) (Subchapter S of Chapter 1) of the Code permit certain small business corporations with a limited number of shareholders and only one class of stock to elect, with unanimous consent of shareholders, to have taxable income or net operating loss of the corporation treated as income or loss of the shareholders rather than of the corporation. Under Section 1378, however, the corporation will be taxed on net capital gains in excess of \$25,000; it will be taxed on its entire taxable income if an attempted election does not meet the requirements of Section 1372; and it will be taxed on its entire taxable income if the corporation itself does not fulfill all of the requirements of Section 1371. Section 6037 requires that each purported S corporation file an annual return of income that will serve as both an information return with respect to its shareholders and its own corporate tax return with respect to income taxable under Section 1378, if an attempted election does not meet the requirements of Section

⁴ A complex trust is a trust that is not required to distribute all of its income currently. See 26 U.S.C. 651(a), 661(a).

⁵ The Tax Court, in a unanimous reviewed decision, has refused to follow *Kelley* in cases other than those appealable to the Ninth Circuit. *Fehlhaber v. Commissioner*, 94 T.C. 863 (1990), appeal pending, No. 90-5735 (11th Cir.).

1372, or if the corporation itself fails to meet the qualifications required by Section 1371.

In the *Kelley* case, shareholders in an S corporation consented to the extension of the statute of limitations with respect to the 1980 taxable year, but the Commissioner neither requested nor obtained such consent from the S corporation. More than three years after the returns of the shareholders and the S corporation had been filed, but within the extended period consented to by the shareholders, the Commissioner asserted deficiencies against the shareholders arising from the disallowance of deductions claimed on their individual returns that resulted from losses of the S corporation. The court of appeals relied on language in Section 6037⁶ to hold that, since the S corporation had not agreed to extension of the statute of limitations, Section 6501 barred the assessment of a deficiency against the shareholders attributable to income or loss derived from the corporation.⁷ We

⁶ Section 6037 describes the return filed by an S corporation, for purposes of "limitations," as "a return filed by the corporation under Section 6012." 26 U.S.C. 6037. Section 6012 requires the filing of returns by corporations that are "subject to taxation under subtitle A." 26 U.S.C. 6012(a)(2).

⁷ Corporate dividends are perhaps the most common form of derivative income. They are taxable to the recipient shareholder only to the extent that they either are distributed out of the earnings and profits of the corporation accumulated since February 28, 1913, or out of the earnings and profits of the taxable year. See Sections 301(a) and (c) and 316(a). It is thus obvious that the taxable status of a current dividend may depend upon an analysis of earnings and profits for many years prior to the year at issue. See, e.g., *Commissioner v. Munter*, 331 U.S. 210 (1947); *Commissioner v. Goldwyn*, 175 F.2d 641 (9th Cir. 1949). See *Helvering v. Canfield*, 291 U.S.

believe that the decision is erroneous, and that Section 6501(a) provides a statute of limitations for assessments of deficiencies on "the return" of the *taxpayer*, and not on the return of some *other* entity (e.g., partnership or subchapter S corporation) from which the taxpayer has derived income or deductions. Unlike the case of a partnership, however, the S corporation files a return that reports not only income or loss attributable to its stockholders but also income that is (or may be) taxable to it. By contrast, the return of a partnership is purely informational because the partnership is not taxable in any context, and the return it files reports no tax attributable either to itself or to its constituent partners. Cf. *Automobile Club v. Commissioner*, 353 U.S. at 188. ~~and the operation of Sections 666 and 667, how-~~

b. The *Fendell* case, which involved the beneficiary of a complex trust, followed the pattern of the *Kelley* case, and the court of appeals invoked the *Kelley* decision as authority. See 906 F.2d at 364. A trust is an entity subject to the income tax applicable to individuals (Section 641) and is required to file an annual return of its income and tax (Section 6012(a)(4) and (b)(4)). The distribution of income by a complex trust gives rise to a deduction for the trust (Section 661) and gross income for the beneficiary (Section 662). Due to the definition and effect of "distributable net income" in Section 643 and the operation of ~~of~~ Sections 666 and 667, how-

163 (1934). It has never been suggested that the statute of limitations that would bar assertion of a deficiency against the corporation would bar the assertion of a deficiency against a shareholder with respect to a current dividend the taxable status of which required an analysis of earnings and profits for many years in the past.

ever, the amount of the deduction and income are not always the same.

As in *Kelley*, the Commissioner in *Fendell* obtained a consent to extension of the statute of limitations from the trust beneficiary, but did not seek or obtain an extension from the trust. Also as in *Kelley*, the Commissioner asserted a deficiency (resulting from disallowance of deductions relating to distributed trust income) against the beneficiary during the extended period.

In *Fendell*, as in *Kelley*, we believe that the court of appeals erred in concluding that the deficiency asserted against the beneficiary was barred under Section 6501. Whether trust income, S corporation income or partnership income is received by a taxpayer, "the return" referred to in Section 6501(a) is the return of the taxpayer and not the return of some other entity. But, in *Fendell*, the trust is subject to income tax and, unlike a partnership, files a return showing its own tax liability as well as serving as an informational return with respect to distributions to beneficiaries. Thus, additional issues are presented in both *Kelley* and *Fendell* that are not pertinent to the present case and were therefore neither presented nor considered in the court of appeals. In this context, it cannot be said unequivocally that a direct conflict exists among these decisions, although, in our view, a conflict in reasoning and in principle is plainly present.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

KENNETH W. STARR

Solicitor General

SHIRLEY D. PETERSON

Assistant Attorney General

ANN B. DURNEY

JANET KAY JONES

Attorneys

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